

VZCZCXRO2724
PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV RUEHSR
DE RUEHLO #0187/01 0221651
ZNR UUUUU ZZH
P 221651Z JAN 09
FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC PRIORITY 1114
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUCPDOG/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBL/AMCONSUL BELFAST PRIORITY 1212
RUEHED/AMCONSUL EDINBURGH PRIORITY 1060

UNCLAS SECTION 01 OF 02 LONDON 000187

SIPDIS

E.O. 12958: N/A
TAGS: [ECON](#) [EFIN](#) [ETRD](#) [EINV](#) [UK](#)
SUBJECT: GOVERNMENT ANNOUNCES THIRD STRAND OF ECONOMIC RECOVERY
PACKAGE

REF: 08 State 134459

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11. (U) HMG announced new measures to reinforce financial stability and ensure the resumption of lending on January 19. To improve banks' access to wholesale funding markets, HMG will provide full or partial guarantees to eligible AAA-rated asset backed securities from April. Additionally, HMG will extend the drawdown window of its existing credit guarantee scheme from April 9 to December 31. To address the loss of mortgage lending capacity, HMG said Northern Rock will no longer need to actively pursue a policy of rapidly reducing its mortgage book to repay its government debt. To increase the availability of corporate credit, the Bank of England will establish an asset purchase scheme, authorized by HMT, to buy up to GBP 50 billion high quality private sector assets, financed by the issue of Treasury bills. (Note: HMT said this facility could be used by the Bank's Monetary Policy Committee as a way to meet its inflation target of two percent - potentially paving the way for quantitative easing. End note.) To reduce banks' uncertainty about the value of past investments, HMG will offer capital and asset protection on assets most affected by economic conditions (details of this measure are expected in February). To provide banks with access to long-term liquidity, the Bank of England will extend its Discount Window Facility, increasing the length of time assets can be swapped for from 30 days to one year. Finally, HMT said in the longer term, it will work with the FSA to incorporate counter-cyclical measures into capital ratio requirements, requiring banks to build up buffers in good years that they can draw on during economic downturns.

12. (U) Prime Minister Gordon Brown said the measures focus on helping British banks struggling to fill a gap in credit provision left by the retreat of foreign and non-bank lenders. He said the package was the third part of HMG's strategy following last year's bank recapitalization program and subsequent fiscal stimulus measures. He stressed the importance of working in partnership with other countries facing the same problems and preventing a "damaging de-globalization" and return to protectionism. Chancellor Darling told MPs the measures would remove uncertainty and accelerate the resumption of lending, a necessary precondition for recovery.

Package Has "Reasonable Chance" Of Success

13. (U) HMG's package has a "reasonable chance" of unblocking the flow of credit within the banking system and capital markets, according to Paul Tucker, Executive Director of Markets at the Bank of England. Tucker told MPs of the Treasury Committee that there are no silver bullets, but that he believes it is a good package. He said the asset purchase scheme, whereby the Bank will have the authority to purchase high quality corporate bonds, does not immediately amount to quantitative easing. However, he did not totally reject suggestions that this might happen soon. He warned MPs that the UK package needs to be accompanied by similar packages

internationally if it is to succeed. Tucker, soon to be responsible for financial stability at the Bank, supported HMG's fiscal stimulus but said it is vital that the government make a credible commitment to get the public finances on a sustainable footing. Mervyn King, Governor of the Bank of England, showed support for HMG's package during a speech in Nottingham. He said asset purchases can increase the supply of money and credit, thereby increasing spending. He warned, however, that there is a fine line between helping to oil the wheels in markets which are temporarily impaired, and artificially supporting markets in which there is no underlying demand. Therefore, the Bank will need to be satisfied that there is genuine demand for the asset in normal conditions before it is eligible for the asset purchase facility. King also noted that such purchases involve taking more credit risk onto the public sector balance sheet.

14. (U) HMG's measures will be critical to increasing lending to the economy, according to the British Bankers' Association. The Council of Mortgage Lenders welcomed the broad thrust of the package, particularly the guarantee scheme for asset-backed securities which, it believes, will help restart the securitization market. If the measures are fully implemented, they should stem a downward recessionary spiral and provide a stable economic platform, according to the Confederation of British Industry, which welcomed HMG's bold response to the economic downturn. It welcomed the "extra extraordinary" policy solutions and said they are essential pre-cursors for economic stability, which will expand the availability of credit, open new channels of credit and get the economy working.

Market Reaction

15. (U) The market and public reaction to the latest set of government initiatives suggest there is no confidence that HMG's

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policies are working, according to Conservative Party Leader David Cameron. Cameron's comment during the Prime Minister's Questions, January 21, alluded to the reaction of bank shares following the Chancellor's announcement on January 19: Barclays' share price fell 17 percent; Lloyds Banking Group fell by almost a third; and RBS closed down 67 percent. (Note: These large declines are also attributable to rumors of further nationalizations in the banking sector. End note.) Sterling fell to its lowest level against the U.S. dollar in more than five years, hit a record low against the yen and fell against the euro following the announcement. This weakening is partially explained by fears that the rescue package will substantially increase the UK's debt beyond the 8 percent of GDP projected by the Chancellor in his Pre-Budget report.

TUTTLE